Franchise Law Alert
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Navigating the franchise credit crisis

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According to Darrell Johnson, CEO and President of FranData, tight credit is "the single biggest constraint on franchise growth." While franchising is usually a countercyclical business that often prospers in a down economy, in the current economic cycle limited access to capital is hurting franchising. In a November 13, 2009 presentation to Nixon Peabody's Franchise & Distribution Team, Mr. Johnson, a nationally respected consultant and commentator on franchising, detailed the impact of the credit crisis on the business of franchising.

During the franchising boom years from 2000 to 2007, system growth was fueled in part by easy credit, often supplied through preferred lender networks developed by franchisors. According to Mr. Johnson, this easy credit allowed many franchise systems to expand and prosper even though their systems and operations were not optimized. When the credit crisis hit in 2008, the ability of franchisors or franchisees to obtain credit froze. Now, while lending institutions have more reserves and a greater ability to loan, the banking industry is taking a very conservative approach to lending, which has resulted in a continuation of the credit crunch.

Mr. Johnson, who describes himself as a recovering banker, commented that banks are returning to their time-tested approach to lending, including rigorous review of financial qualifications of both franchisors and franchisees prior to extending credit. Further, many large national banks are stepping away from franchise lending, resulting in more focus on community banks, institutions that have less knowledge of franchising. Mr. Johnson counsels that all of these changes necessitate a new approach by franchisors and franchisees in dealing with lending institutions.

With community banks often a better source of credit, to get those loans franchisors and franchisees need to provide financial qualification data in a way that is understandable and persuasive to bankers who have little experience with franchising. Central to successfully obtaining credit in this lending environment is standardizing franchise performance reporting so that lending institutions can understand and accurately assess the risks and opportunities involved in extending credit to both franchisors and franchisees.

From the perspective of a franchisee seeking credit, lending institutions are not only interested in the franchisee's credit worthiness and the potential unit performance metrics, but also in the stability and long-term strength of the franchise brand. Thus, it is essential to offer standardized data to lending officers on the quality of the franchisor's support, the brand strength, the performance of other existing franchisees, and the earning potential. Many of these lending officers are in community banks who have little knowledge of franchising, so standardized reporting of this type is critical to obtaining credit. According to Mr. Johnson, providing this data will help overcome the current mindset of bankers, which is "not focused on making money as much as on not losing money."

Mr. Johnson's solution to the challenges posed by this new lending environment is standardized bank credit reports for franchised companies that explain the performance of franchise companies in lending terms. These franchise bank credit reports will focus on three primary risk areas: (1) franchisor operational and financial strength; (2) franchise system continuity and stability; and (3) franchise unit economics. Mr. Johnson believes that using standardized franchise bank credit reports with banking language and credit department formats will enable loan officers to more easily assess the risks and opportunities associated with extending credit to franchise companies. As Mr. Johnson commented, "In many ways, the bank credit reports are the equivalent of completing the underwriting analysis related to the franchise brand for lending officers." In an environment where so much of the credit available to franchise companies is coming from banking institutions with no long-term experience in the industry, Mr. Johnson believes that providing standardized franchise bank credit reports will make it easier to obtain credit.

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